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C O N F I D E N T I A L SECTION 01 OF 04 HARARE 001239

SIPDIS

AF/S FOR B. NEULING
STATE PASS USAID FOR M. COPSON
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TREASURY FOR J. RALYEA AND B. CUSHMAN
TREASURY FOR JOANN CHIN
USDOC FOR ROBERT TELCHIN

E.O. 12958: DECL: 12/31/2010
TAGS: ECON EFIN ETRD PGOV ZI
SUBJECT: IMF MISSION FINDS MODEST REFORM MEASURES, HEARS MORE PROMISES

Classified By: Ambassador Christopher Dell for reasons 1.4 (b) and (d)

SUMMARY

¶1. (C) Summary. An IMF mission was in country from August 22-September 1 to give advice, assess economic policies, and review the strength of the GOZ,s commitment to economic reform prior to the September 9 meeting of the Fund's Executive Board. The team acknowledged recent modest progress by the Reserve Bank of Zimbabwe (RBZ) in tightening monetary policy, but saw little prospect of an improved fiscal situation in 2006. Massive overspending in the first half of 2005 plus high wage and interest bills had led to considerable fiscal expansion and were feeding inflation. The team reduced its forecast of the fiscal deficit to 11.3 percent from 14.2 percent in May, as a result of measures the GOZ took in the July supplemental budget, but projected an annualized rate of inflation of 400%, or higher, by end-2005. The team relayed Reserve Bank Governor Gono,s claim that the recent arrears payment of US$120 was funded by working capital repatriated as a result of devaluation and higher interest rates, and a short-term borrowing facility, but expressed some skepticism about Gono's explanation of the source of the payment. The GOZ continues to blame its economic woes on two forces out of its control: drought and U.S./EU sanctions. The IMF team said that the adjustment measures of the last weeks were modest and did not constitute a comprehensive reform package.

Some Reforms, More Promises from Gono

¶2. (C) Mission Chief Coorey said the GOZ had initiated some reforms since the June Article IV mission, which concluded that economic and social conditions had deteriorated sharply over 2004. Since June, Reserve Bank Governor Gono has tightened monetary policy by devaluing the currency (from Z$8,500 to the US$ at end-May, to Z$24,500 at end-August) and raising interest rates. The spread in the parallel market premium had narrowed to some 100 percent, down from about two and a half times the official rate in early August. The pace of the Reserve Bank of Zimbabwe,s (RBZ) foreign exchange losses from subsidies to importers and persons with preferential access to foreign exchange has fallen. The picture is nevertheless mixed, with some producer subsidies, such as the tobacco subsidy, having been cancelled, while others, on cotton, for example, have increased. Losses accumulating from quasi-fiscal measures, in particular the high cost of interest payments resulting from liquidity support in 2004 to insolvent commercial banks, amount to a staggering 20 percent of GDP, according to Coorey. The mission advised the GOZ to terminate quasi-fiscal activity (not simply move it to the budget); otherwise, the RBZ would have to continue to print money. The team further urged the GOZ to liberalize the exchange rate and limit the role of the RBZ to maintaining exchange rate stability. Coorey commented that the RBZ had lost considerable staff in the last months. Reserve Bank expertise, except in the area of bank supervision, had thinned. Gono had expressed interest in getting technical assistance on exchange rate liberalization.

¶3. (C) Coorey reported that Gono is not averse to moving toward further liberalization of monetary policy. On September 1 he announced withdrawal of the gold support price with immediate effect, with the result that gold will trade at the auction exchange rate. He also announced an end to the cotton support price in January. Coorey said Gono is willing to carry out further monetary measures such as dropping the surrender requirement on exporters, or ending the daily sweep of commercial bank liquidity. The sweep locks funds in for two years at 17 percent interest. However, he intended to postpone the announcement of further reforms until the October monetary statement, and made no commitment on what reforms would be adopted.

Mr. Fix-It,s Credibility at Stake

¶4. (C) Gono is worried about inflation, more so than Minister of Finance Murerwa is, according to Coorey. She estimates inflation will end the year at an annualized rate of 400 percent against Gono,s earlier double-digit projections. If he cannot deliver on inflation, he has failed, by his own admission. She opined that Gono was not in a strong position to ring the alarm bell on the budget, as 10-20 percent of the deficit arises from RBZ activities. As &Mr. Fix-it8, he has taken on too many tasks and is now coming under fire from the Cabinet for having orchestrated devaluation without bringing down inflation, as he promised. Coorey noted that terminating quasi-fiscal support would end profitable rent-seeking activities for favored persons, and was thus politically hard for Gono to force. She complimented him for successfully fighting the battle in 2004 to end liquidity support to insolvent commercial banks, but noted that, soon after, an amendment was passed requiring the Reserve Bank Governor to consult with the Minister of Finance before canceling banking licenses. She commented that Gono goes to Mugabe for approval on the smallest of issues. He could not sign, for example, a public letter or make a commitment on capping the PLAP (Parastatals and Local Authorities Re-Orientation Programme Facility) without consulting first with Mugabe.

Bleak Fiscal Outlook

¶5. (C) The mission reduced its fiscal deficit projection from 14.2 percent in May to 11.3 percent, based on tax measures and spending cuts introduced in the GOZ,s July supplemental budget. The hangover from a massive spending binge in the first half of 2005 and high wage and interest bills are the major impediments to narrowing the deficit further. Murerwa recognizes the seriousness of the wage bill problem) wages amount to 20 percent of GDP - but is noncommittal as to what action to take. He told the mission team that pension and civil service reform would be fleshed out in the 2006 budget. He noted it would be &very difficult8 to reduce expenditure in the 2006 budget. Coorey pointed out that the high cost of maintaining the state,s security apparatus was also contributing to inflation. She anticipated that the fiscal position would remain unchanged in 2006. Measures such as taxation of the transportation and housing allowances, plus medical aid insurance, could generate a further one percent of GDP in revenue, but the social cost would be high. She doubted the GOZ would follow through in this fiscal environment and spend the Z$300 billion earmarked in the supplemental budget for &Operation Garikai8, the GOZ,s reconstruction program in the wake of Operation Restore Order.

¶6. (C) Kevin Fletcher, the IMF team fiscal expert, commented that his interlocutors were shocked at the magnitude of the fiscal problem once the IMF team exposed it to them. The RBZ did not realize the cost of its quasi-fiscal activities, in particular forex subsidies, gold price support, the cost of liquidity support to commercial banks, and the high cost of interest. Against GOZ instinct to hide the numbers and their effects, the mission advised shedding light on the fiscal and political cost of policy decisions by making provisions in the budget. Coorey advised Gono to make a point of showing the politicians the real cost of policies.

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Sources of the Arrears Payment) According to Gono
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¶7. (C) Gono explained to Coorey that 70 percent of the recent arrears payment to the IMF was sourced, at the auction rate, from the return of working capital that had fled the country, but was attracted back as a result of devaluations and rising interest rates. The remaining 30 percent was from a short-term financing facility (source unstated) repayable in 2006. She expressed some skepticism about Gono's explanation of the source of the payment, noting there were inconsistencies in his public and private explanations. She said Gono believed he had had to deliver to the IMF fast, as expectations were rising, the press had focused on repayment and the impending September 9 IMF Board vote, the publicity was damaging to Zimbabwe,s image, and internal politics had become particularly difficult. The GOZ was not giving up on negotiating a loan from South Africa, but had not expected negotiations to conclude in time to pay the IMF before September 9, given the complications caused by the extensive press coverage. Gono expressed the desire for a &program relationship8 with the IMF and said he expected to clear remaining arrears by the end of 2006.

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The IMF Mission Assessment) Balancing GOZ Actions and

Promises
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¶8. (C) Coorey dodged the Ambassador,s direct question of staff,s recommendation to the Executive Board. She insisted the IMF,s decision whether to recommend compulsory expulsion to the Board would be made at a much higher level than hers. &It,s anybody,s guess8, she said. She agreed that the GOZ,s recent measures were modest and did not constitute a comprehensive reform package. While Gono may have a sense of urgency, Murerwa and politicians appeared less concerned. Her assessment to headquarters would attempt to balance the recent adjustment policies and promises of further policy reform with past performance and political realities. Coorey also ruefully agreed with the Ambassador's observation that the GOZ was once again hoping to squeak past an Executive Board review of its overdue obligations by adopting a minimum package of reforms (and a large payment on arrears), and promising further improvements at a future date, all designed to string us along and avoid tough decisions.

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Drought and Sanctions) &The Causes of all Zimbabwe,s Economic Woes8
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¶9. (C) Coorey related that the GOZ took every opportunity to blamed its economic woes on two forces out of its control: drought and US/EU sanctions. She pointed out to GOZ officials that FAO rainfall charts showed a range of normal rainfall in the peak growing season of October through December 2004, but they insisted the rains hadn,t fallen at the crucial time in the right places. Regarding sanctions, GOZ officials would not accept that U.S. and EU sanctions were targeted solely against specifically identified individuals and their business activities, and not Zimbabwe itself. She said her interlocutors were convinced that the U.S. is warning private companies not to do business in Zimbabwe.

Comment and Recommendation

¶9. (C) GOZ posture toward the IMF delegation follows a familiar pattern of privately acknowledging mistakes and undertaking modest measures - to be implemented largely at unspecified times in the future. In fact, the government's rhetoric with domestic audiences has not strayed at all from its extreme command and control approaches of the past five years. As with so many of its economic challenges, the GOZ's strategy is just to make it to the next day, in this instance to forestall IMF expulsion, with no credible and comprehensive long-term recovery plan. While Zimbabwe's surprisingly large payment may impress some, we see no evidence that Gono and his crew will be any more able to deliver reforms than they have in the past. Indeed, Gono is skating on increasingly thin ice politically. Depending entirely on the impulsive President's favor and not lacking in enemies, he is a prime scapegoat candidate to take the fall for the country's deepening economic distress. For their part, Mugabe and his cohorts betray little or no understanding of the underlying causes of the country's accelerating collapse nor their own responsibility for it through gross mismanagement.

¶10. (C) In view of the GOZ's large payment of arrears, we understand it is unlikely that we can muster the votes necessary for the Executive Board to recommend compulsory withdrawal to the Board of Governors. Coorey also continues to frustrate by her unwillingness to draw a bottom line under the GOZ's performance, and we have little expectation that she or IMF senior management will advocate forcefully for a tough position. While it may not be feasible under these circumstances to achieve a vote for compulsory withdrawal, we nonetheless believe the GOZ should not be let off the hook. We recommend pushing as hard as possible for compulsory withdrawal while working behind the scenes to obtain a Board vote of censure against the GOZ. To let Mugabe, Gono and company get away with nothing more than another six month reprieve will only encourage more of the same from them and undermine the IMF's credibility.

DELL